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A Change in Plans for Lenders and Borrowers

Since the very nature of a suggested change in a development plan is a business decision, how can lenders assist borrowers and maintain their collateral while averting liability?

THE CURRENT ECONOMIC CRISIS has perhaps hit no industry as hard as the real estate development industry. Construction and development loans made two or three years ago are now coming due in a marketplace vastly different, and largely unimagined, by lenders and borrowers alike. Loan officers and servicers are spending much of their time negotiating extensions for loans that cannot be repaid due to the collapse of underlying markets, especially concerning residential and retail properties. Nearly as often, however, they are presented with alternative models of the business or development plans approved by the lender at loan origination. Do officers and servicers have a duty to review these proposals, and if so, are they obligated to approve plan modifications?

For the most part, it is not only appropriate for loan officers and servicers to review borrowers' modified plans, but also good business practice. Developers and owners, after all, are likely to understand the highest and best use of their projects better than anyone else, and lenders should be interested in permitting their collateral to reach its maximum value.

Tension exists, however, between the interests of developers—guarantors, in particular—and the aims of first-position lenders when it comes to repositioning developing properties. Lenders may not wish to accept additional project risks where a recourse borrower maintains adequate assets. Borrowers, on the other hand, may demand that lenders respond reasonably to ideas geared to save troubled developments.

The most common change contemplated amid the residential market collapse is a "reverse" conversion from condominium units to apartments. Such conversions are not taking place solely during the construction phase either. Due to the low presale limits of the past few years, developers around the country have numerous completed, but empty, buildings without significant sales contracts in place. Developers are understandably reluctant to sit with empty units while their loans race toward maturity. They may approach lenders for consent to rent units, which may not be allowed under the loan documents, as well as for a conversion of the construction loan to a term loan to cover the period through stabilization.

For-sale developers may also seek to modify specific loan restrictions, such as minimum sales prices and lot or unit sizes. A drop in minimum sales price may make particular sense where a bulk buyer is available to contribute dollars toward a pay down of the loan, or may just be needed to bring home prices to market level. Similarly, unit size adjustments may be an approximate reaction to market conditions. Developers of nonresidential property also may desire changes. For example, it may make sense to convert a portion of an office building to apartments, or a borrower may wish to depart from specific tenant guidelines to broaden its ability to market retail space. Many borrower proposals will make good economic sense, but in each case, the borrower will be asking the lender to renegotiate terms previously negotiated and underwritten. In many cases, the modifications will be akin to making new loans, in that more time or new money will be requested. At issue are a lender's obligations upon receiving such requests, as well as the best method of moving forward.

Generally speaking, lenders have limited legal responsibility to review borrowers' proposed modifications. There are arguments, however, that a borrower can make if it believes that a lender has failed to act reasonably in light of changed circumstances in the real estate market.

U.S. courts have, from their inception, found that parties to a contract have an implied duty of good faith and fair dealing written between the lines of their specific contract terms. A federal court in Tennessee applied this duty to lenders in the 1985 *Irving Trust* decision. In that case, a borrower argued that a lender's refusal to fund a credit line led to the collapse of its grocery business. The court agreed, reasoning that without an implied good faith duty, the success or failure of the borrower's business would be at the "whim" of the bank. To a lesser extent, other courts also have determined that lenders are subject to the implied duty of good faith.

Fortunately for lenders, the majority of jurisdictions have disagreed with *Irving Trust* and the above reasoning. Courts in Minnesota, Oklahoma, and Pennsylvania, for example, have refused to recognize an implied duty of good faith in loan documents. Those courts reason that a contracting party's duty of good faith cannot force a lender to waive rights to which it is entitled by the terms of its contract or by law. Moreover, a lender does not breach a duty of good faith by negotiating favorable loan terms for itself. Most loan documents are very favorable to lenders and to imply new terms would be to effectively shift the risk inherent in making commercial loans.

Aside from good faith, borrowers have attempted other arguments geared toward requiring lender reasonableness. One real estate developer alleged that its inability to obtain private mortgage insurance, which was a prerequisite for approval of purchase money mortgages was akin to "commercial

frustration," because the developer could not perform its obligations under the loan agreement. Another argument made, albeit unsuccessfully, has been a borrower's claim that its lender had a duty to mitigate damages resulting from a failed project.

For reasons similar to the decisions involving good faith, courts have consistently rejected these efforts, preferring instead to protect the lender's broad right to enforce its documents to the full extent of their provisions. This rationale makes sense in the context of traditional mortgage loans. Mortgage lenders, after all, are not business partners. They are not investing in the upside in their borrowers' projects and they have underwritten only the specific risk of the approved loan terms and remedies.

In most jurisdictions, then, lenders are not required to modify business, development, and/or construction plans from the forms attached to or referenced within existing loan documentation. That said, in many cases, lenders would find it in their best interests to allow borrowers to depart from an outdated plan.

In today's economic environment, requiring the sale of luxury homes that were priced five years ago is similar to forcing a borrower to sell Hummers to a showroom of Prius shoppers. Obviously, lenders do not want to take back property in this environment and, as a consequence, should be open to fresh ideas as to how to increase collateral value. If a lender does decide to review a modification proposal, however, it needs to be careful in how it communicates with its borrower.

Lenders may owe the borrower a fiduciary duty if they exercise control over the day-to-day business of the borrower. They are generally permitted to protect themselves through the exercise of their default remedies without triggering lender liability, but a fiduciary obligation can arise if a lender inserts itself into a business-decision role.

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Approving or denying a borrower's proposal does not, in itself, make a lender liable for breach of fiduciary obligation. The criteria for finding lender liability include the exercise by the lender of dominion, control, or influence over the affairs of its borrower. So, for example, if a borrower presents the lender with a plan to convert condominiums to apartments, the lender might agree and amend loan documents accordingly. The lender should avoid taking a more active role in the change in plan, such as suggesting a specific change in architecture, or worse, a legal course of action concerning the existing unit purchasers.

Lenders can and should answer the phone when their borrowers call to discuss improvements in their business plans to adjust to market conditions; however, they are under no obligation to agree to do so. When lenders do agree to listen, they should act to approve or disapprove, but should not take charge of any aspect of a proposed change in plan.

Borrowers can and should call their lenders long before they default on their loan, and should do so early enough for a meaningful conversation about alternative plans or proposals. They should also remember that lenders do not have to agree to any of their requests, but that in today's real estate market, it could behoove a lender to at least listen to a new idea.

Given the upheaval in real estate markets, it is possible that courts may in the future become more sympathetic to claims that the duty of good faith is implicit within loan documents. If a lender acts fairly, but remains in a traditional lender role of review, then it will be able to assist its borrowers in maximizing value, without incurring legal liability. UL

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